IN THE

Supreme Court of the United States

October Term, 1977

No. 77-99

UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE,
Petitioner,

v.

BEAR, STEARNS & CO., et al.,
Respondents.

BRIEF OF RESPONDENT BLYTH EASTMAN DILLON & CO. IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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Respondent Blyth Eastman Dillon & Co. respectfully submits its Brief in Opposition to the Petition for a Writ of Certiorari herein.

QUESTION PRESENTED

Whether, in the absence of (1) allegations of scienter and (2) lack of fault by the plaintiff as defined by Regulation X of the Federal Reserve Board, extensions of credit by a broker to its customer in violation of Regulation T of the Federal Reserve Board give rise to a private cause of action or an absolute liability remedy.

STATEMENT OF THE CASE

The presentation of a single petition concerning eight companion cases, each standing on its separate facts renders the Statement of the Case presented by Petitioner Utah State University of Agriculture and Applied Science [the University] so misleading, particularly as to Respond Blyth Eastman Dillon & Co. [BEDCO], that a separate statement is both necessary and appropriate.

The complaint alleges that the University purchased stock through BEDCO, acting as its broker, pursuant to formal resolutions of the University's Institutional Council (its governing board) (A-2). The resolution, delivered to BEDCO and retained in its files, provided that the University's investment officer, Donald Catron [Catron], a sophisticated accountant, businessman and former securities salesman (A-3), had authority to act for the University "until written notice of the revocation hereof shall be delivered to" BEDCO (A-2).

Pursuant to the resolution the University established a cash account with BEDCO in 1971 and in 1972 the University established purchase against delivery [PAD] accounts with BEDCO. Pursuant to the PAD account, payment by the University, which otherwise would be due within seven days of the date of purchase,[1] could be delayed until the securities were actually delivered, provided the securities were delivered within thirty-five days of purchase date and the University paid upon delivery.[2] Catron instructed BEDCO to make deliveries to one of the University's banks in Logan, Utah.

In the Spring of 1972, the Utah State Auditor's office notified Catron that an audit would be made on the Uni-

[1] 12 C.F.R. Part. 220, cited at A-10.

[2] 12 C.F.R., §220.4(c)(5).

versity's investment program. That prompted Catron to engage in a series of transactions which are the subject of this action, in which he sold stock through one broker and immediately repurchased the same stock utilizing another broker. The effect of this device, when employed with the PAD accounts, was that the University received immediate payment for the stock sold but did not have to pay for the stock bought until its delivery (A-3), thus improving the appearance of its cash flow over a short period of time.

The University then instructed Catron to stop purchasing securities on its behalf, but did not revoke his authority with BEDCO or any other broker until four months later. Many of the transactions complained of fell within that four month period.

With respect to all purchase transactions in which BEDCO was involved, *all* securities were delivered for payment within thirty-five days of the trade date. The University correctly states that, in some instances, it failed to pay for these securities upon delivery or within the thirty-five day period, contrary to its agreement in establishing the PAD account.

With respect only to those securities so purchased which eventually declined in value, the University filed suit against BEDCO contending that BEDCO had violated Section 7(c) of the Exchange Act [15 U.S.C. §78g(c)] and Federal Reserve Board Regulation T thereunder (12 C.F.R. part 220) by failing to liquidate the University's account at the end of the thirty-five day period in those instances where the University had failed to make timely payment. The complaint did not allege "scienter" or any intentional misconduct, or acts tantamount to fraud, or that the University did not have knowledge of or consent

to the transactions. Neither does the complaint allege that the violations of Regulation T "caused" either the transactions or any eventual losses or that the University would not have engaged in the transactions had Regulation T been complied with. The United States District Court for the District of Utah granted BEDCO's motion to dismiss for failure to state a claim upon which relief could be granted and the Court of Appeals for the Tenth Circuit affirmed.

REASONS FOR DENYING THE WRIT

These cases center upon the interface of Sections 7(c) and (f) of the Securities Exchange Act of 1934, [15 U.S.C. §78g(c) and (f)], and Federal Reserve Board Regulations T (12 C.F.R. part 220) and X (12 C.F.R. part 224) promulgated, respectively, thereunder.

Section 7(c) of the Exchange Act and Regulation T require that a broker liquidate PAD accounts such as those established by the University if payment is not made within thirty-five days of purchase. In 1970, over Justice Friendly's vigorous dissent, Regulation T was held to impliedly create a civil remedy for damages in favor of a customer for a broker's negligent violation of the regulation, even where the customer was at fault.[3] *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971) [*Pearlstein I*].

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[3]Judge Waterman, speaking for the *Pearlstein I* majority answered the objection that the plaintiff should be denied recovery because he was *in pari delicto* with the observation that:

> the federally imposed margin requirements forbid a broker to extend undue credit but do not forbid customers from accepting such credit. This fact appears to indicate that Congress has placed the responsibility for observing margins on the broker . . .

That holding provoked Judge Friendly's vigorous dissent in which he recognized that the purpose of Regulation T was not to protect individual investors but rather the economy and that an implied right of action created more problems than it solved.

Congress responded to the apparent inequity of *Pearlstein I* by enacting Section 7(f) [15 U.S.C. § 78g(f)], making it unlawful for a customer to *accept* proscribed extensions of credit and Federal Reserve Board Regulation X was promulgated thereunder specifying generally that it was illegal for a customer to obtain credit which did not conform to the provisions of Regulation T.

The enactment of Section 7(f) prompted the Second Circuit to disavow its *Pearlstein I* holding in *Pearlstein v. Scudder & German*, 527 F.2d 1141, n.3 (2d Cir. 1975) [*Pearlstein II*]:

> [T]he addition of Section 7(f) to the Exchange Act of 1970, 15 U.S.C. §78g(f), as well as the promulgation by the Federal Reserve Board of Regulation X, 12 C.F.R. §224 (1975), have now made it unlawful to obtain credit in violation of the margin requirements. *The effect of these developments is to cast doubt upon the continued viability of the rationale in our prior holding.* (emphasis added)

The University in effect urges this Court to ignore the enactment of Section 7(f) and adopt the discarded authority of *Pearlstein I*.

The representations at Pet. 4 that the Court of Appeals held that "no private cause of action exists for violations of Regulation T" and at Pet. 8 that "[t]he Opinion below is not clear whether the Court merely refused to . . . [allow] private causes of action to enforce Regulation T . . . or whether the Court's holding was based on the 1970 amendment and Regulation X promulgated under the amendment" are misleading, for the Court of Appeals clearly held "that in an appropriate case there may be an implied cause of action for private redress for violation of [National Association of Securities Dealers] or

exchange rules" (A-8-9) or under Rule 10b-5 (17 C.F.R. §240.10b-5) if there is "scienter" as defined in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, *reh. denied* 425 U.S. 986 (1976). While this holding was not expressly applied to Regulation T its application to the general fraud provisions leaves the Court's intent sufficiently clear. Moreover, the Court's inclination to apply this holding to an appropriate Regulation T claim is made explicit by its distinguishment of two district court cases[4] imposing liabilities based upon Regulation T as "not pertinent because the complaint[s] alleged fraud and deceptive conduct" (A-12).

In light of the complaint's failure to allege the elements of scienter required by this Court in *Hochfelder*, and considering (as demonstrated hereafter) that *every* court which has considered the Section 7(c) - 7(f) interface has applied an equal fault standard, the University has not advanced an issue worthy of review. Factually this case does not present the issue posed and, in any event, the question is premature until such time, if ever, the lower federal courts announce conflicting interpretations of the Section 7(c) - 7(f) interface.

I. THE ISSUE ADVANCED IS NOT RIPE FOR REVIEW

A. *The University Concedes That There is no Conflict Among the Circuits.*

The University correctly concedes that no other Court of Appeals has yet considered the Regulation T — Regulation X interface (Pet. 11, 16). Thus, the University urges this Court to consider an imaginary conflict on

[4] Lantz v. Wedbush, Noble, Cooke, Inc., 418 F. Supp. 653 (D. Alas. 1976); Neill v. David A. Noyes & Co., 416 F. Supp. 78 (N.D. Ill. 1976).

which the jury is not yet in. This Court should address itself to real issues and grant the circuits an opportunity to explore a conflict, should it ever appear. R. Stern & E. Gressman, Supreme Court Practice §4.3 at p. 154 (4th ed. 1969).

B. *No Issue of Overriding Importance is Presented.*

The University's assertion that this case presents issues meriting review rests on its two stage assertions at Pet. 5-9 that (1) other courts have held that Section 7 and Regulation T "*may* be the basis for a private civil action for damages" (Pet. 5, emphasis added) and (2) Section 7(f) and Regulation X, which removed the underpinning for *Pearlstein I*, do not make an "innocent mistake" by a borrower a violation of the statute and regulation (Pet. 8). As to both propositions, even if correctly stated, the opinion of the Court of Appeals is in complete accord.

The Court of Appeals carefully examined and implemented this Court's *Hochfelder* decision, and left open the question of liability under Regulation T in cases alleging "fraud and deceptive conduct." Thus, the Court of Appeals for the Tenth Circuit is in line with those courts holding that the statute and rule *may* be the basis for liability, in a proper case.

The Court of Appeals did not reject an "innocent mistake" claim. To the contrary, it took special note of the high degree of fault that the University was guilty of: resolutions confirming authority on its investment officer that were illegal under state law (A-2-3), that "USU seeks to take advantage of its own wrongful acts" (A-9), "that USU [n]ever complained to any broker because of delay in delivery and payment" (A-10) and that the Uni-

versity did not "allege that any particular stock or stocks . . . could have been disposed of without loss" (A-11).

Therefore, contrary to the contrived argument of the University, this case presents no conflict with this Court's time honored implied remedy doctrine announced in *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964). It merely implements the recent pronouncements of this Court requiring that "causation," *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), and "scienter," *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, *reh. denied* 425 U.S. 986 (1976) be alleged and proven.

C. *No Relevant District Court Decision is Inconsistent With the Tenth Circuit's Holding.*

The University argues that the decision of the Court of Appeals herein is inconsistent with a "growing body" of district court determinations (Pet. 11). In fact, no post-Section 7(f) decision advanced by the University has afforded a customer relief against a broker absent a showing of (1) the broker's purposeful misconduct and (2) the customer's lack of fault.

Cases dealing with purposeful misconduct include *Lantz v. Wedbush, Noble, Cooke, Inc.*, 418 F. Supp. 653, 655 (D. Alas. 1976) (Pet. 11, 15), where the Court observed that the plaintiff contestably "alleges that defendant actively mislead plaintiff," and *Neill v. David A. Noyes & Co.*, 416 F. Supp. 78, 80 (N.D. Ill. 1976) (Pet. 11), where an action for damages under Section 7(c) was permitted where "fraud on the part of the broker" was alleged and where "the plaintiffs were . . . innocent customers of the broker-defendant." *Newman v. Pershing & Co., Inc.*, 412 F. Supp. 463, 468 (S.D.N.Y. 1975) (Pet. 11), specifically required an allegation of scienter.

Cases dealing with the customer's fault include *Lantz*, which recognized an *in pari delicto* defense under Section 7(f), and *Palmer v. Thomson & McKinnon Auchincloss, Inc.*, CCH Fed. Sec. L. Rep. ¶96,000 (D. Conn. 1977) (Pet. 8, 11, 12, 14-16), where the court permitted an action under Section 7(c) for an innocent, unknowing investor against a broker who knowingly "attempts to circumvent Regulation T." ¶19,000 at 91,496-97, fn. 20.

In *McNeal v. Paine Webber, Jackson & Curtis, Inc.*, 429 F. Supp. 359, 363 (N.D. Ga. 1977), on which the University places principal reliance, (Pet. 8, 11, 16), the court failed to dismiss plaintiff's Section 7 claim because it was alleged that the broker "affirmatively deceived" the plaintiff. That holding is consistent with this Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, *reh. denied* 425 U.S. 986 (1976) and not inconsistent with the decision herein.

No case cited by the University supports the expansive interpretation requested of this court. Lower court conflict is imagined by the University in its hope to make a fictional issue real.

D. *The Decision Below is not Inconsistent with Federal Reserve Board Policy Statements.*

The University's reference to the Federal Reserve Board question and answer booklet (Pet. 9-11) assumes that the manual is either authoritative or exhaustive. In any event, the language relied upon is inconsistent with the University's position.

The manual correctly states that (1) "contracts made in violation of regulations issued thereunder [are] *void as to the rights of the violator*" (Pet. 10) (emphasis added) and (2) that "[t]he party *not responsible for the viola-*

tion may . . . in a proper case, sue for damages" (Pet. 10 emphasis added). On both points the courts below found against the University's position. The District Court found that the University had violated Regulation X and the Court of Appeals acknowledged the existence and operation of the scheme employed by the University in connection with such violations (A-31, A-3).

If a broker, with the intent to manipulate, deceive or defraud, knowingly violates the requirements of Regulation T to the detriment of an innocent and unknowning customer a civil damage action undeniable may arise under Section 10(b) of the Exchange Act [15 U.S.C. §78j(b)], and Rule 10b-5 promulgated thereunder (17 C.F.R. §240.10b-5). *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, *reh. denied* 425 U.S. 986 (1976). The University, far from being an innocent and unknowing victim, was engaged in a scheme having the purpose and effect of circumventing the requirements imposed upon it by Regulation X.

II. THE FACTS OF THIS CASE ARE INAPPROPRIATE TO RESOLVE THE ISSUE ADVANCED

The question boldly presented by the University (Pet. 3) is one which neither can nor should be decided in any consideration of this case. If the issue ever warrants consideration it should arise from facts which disclose, (1) that a broker failed timely to deliver purchased securities, (2) that in so doing, the broker acted with scienter, (3) that an innocent and unknowing customer was damaged by the broker's manipulative acts. None of these elements are involved in this case.

First, the University does not claim that BEDCO failed to *deliver* any securities within the prescribed thirty-

five day period. The violation of Regulation T alleged, rather, is that *the University failed to pay timely upon delivery* and that BEDCO should be held responsible for the University's default.

Second, the University does not allege "scienter" or any purposeful misconduct by BEDCO, but seeks to reinstate the discarded strict liability concept of *Pearlstein I,* in disregard of the subsequent enactment of Section 7(f).

Third, far from being an innocent customer, the District Court found the University to have knowledge of and *in pari delicto* with respect to the acts alleged. (A-30, 31). The Court of Appeals also acknowledged that the University was engaged in a manipulative scheme designed to improve its apparent cash flow (A-3).

The issue advanced cannot be resolved in a factual vacuum. A definitive pronouncement can only arise from consideration of a case where the issue is more appropriately presented.

CONCLUSION

The petition presents no conflict between the Circuits or issues of overriding national concern. Moreover, the issue presented cannot be resolved on the facts of this case. Accordingly, the petition should be denied.

Respectfully submitted,

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